*United States Court of Appeals*

*for the Second Circuit*

# BRIEF FOR APPELLANT

# 76-5008

In The

# United States Court of Appeals

For the Second Circuit

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Joseph S. Carges as Trustee in Bankruptcy of PAUL R. DEAN & CO., INC.,

*Plaintiff-Appellant,*

*vs.*

AETNA CASUALTY AND SURETY CO.,

*Defendant-Appellee.*

## BRIEF OF PLAINTIFF-APPELLANT

UNITED STATES COURT OF APPEALS
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SECOND CIRCUIT


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| Joseph S. Carges as Trustee in Bankruptcy of PAUL R. DEAN & CO., INC., Plaintiff-Appellant, -vs- AETNA CASUALTY AND SURETY CO., Defendant-Appellee. | : | INDEX TO APPELLANT'S BRIEF |

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Joseph S. Carges as Trustee in Bankruptcy of PAUL R. DEAN & CO., INC.,

Plaintiff-Appellant,

-vs-

AETNA CASUALTY AND SURETY CO.,

Defendant-Appellee.

## STATEMENT OF THE CASE

This is an appeal from a final judgment and order of the Honorable Harold P. Burke, United States District Judge, entered in the Office of the Clerk of the United States District Court, Western District of New York, on January 29, 1976 dismissing this action and awarding costs to the Defendant-Appellee.

In the complaint, Appellant seeks to recover the sum of $250,000 plus interest from April 4, 1973, the fidelity coverage under a certain Stockbrokers Blanket Bond (the "Bond") issued by Appellee (Aetna) to Paul R. Dean & Co., Inc., Bankrupt ("the Bankrupt" or "Dean & Co."). In addition, punitive damages in the sum of $750,000 are claimed against Aetna by reason of its unjustified refusal to make payment under the terms of the Bond and its deliberate efforts to obstruct the efforts of Appellant and his predecessors to collect the face amount thereof. The action was tried before the Court without a jury on July 7th, 8th and 9th, 1975.

## STATEMENT OF FACTS

On August 25, 1966, Dean & Co., was incorporated in the state of New York and commenced the business of selling and trading municipal bonds (T.141*). Its original shareholders were Paul R. Dean, ("Dean") John L. Nichols ("Nichols") and Morton Smookler, all of whom were also directors of the company (T.141, 142). Dean was elected President of the company and was employed as its General Manager pursuant to an employment agreement for an original term of three years with the proviso that thereafter the agreement would be "renewable from year to year". (Exh. 16**; T.143). Nichols was elected Vice President. Morton Smookler surrendered his stock, resigned his position and withdrew from Dean & Co., in December of 1967. Dean and Nichols each became 50% shareholders of the Bankrupt and remained such and also remained as officers, directors and employees of Dean & Co. until the company's demise (T.145).

Upon the formation of Dean & Co., a Shareholders Agreement was also consumated, paragraph 3 of which granted each Shareholder the right to be employed by the company (Exh. 17; T.144). Dean managed the Company's day-to-day operations and Nichols acted primarily in the capacity of arranging outside financing for the company (T.108, 110, 147, 162). Nichols periodically visited the offices, discussed

* Numbers refer to pages of the trial transcript.

** Exhibit numbers refer to exhibits listed in the Index to Record on Appeal.

*** Stipulation numbers refer to stipulations contained in Exhibit 1.

business with Dean and other employees, signed company checks and participated in certain major decisions of the company (T.162, 163, 169, 170, 172, 211 and 213).

The major part of Dean & Co.'s municipal bond business was predicated upon Section 106 of the General Municipal Law which permits contractors of the State of New York municipalities to substitute municipal bonds in lieu of cash retainages and thereby receive interest on otherwise dormant funds. (Exh. 2 and 3, Stipulations 15, 16 and 17 ***; T.43). Instead of physically posting such Bonds with the City of Rochester and the Penfield Central School District, Dean arranged to keep physical possession of the bonds and represented that upon completion of the construction contracts, when the municipalities "released" the bonds they would be repurchased by Dean & Co. from the contractors at their original cost (Exh. 2, Stipulations 15, 16 and 17).

Between March 5, 1970 and April 3, 1973, Dean disposed of certain bonds without authority and also failed to purchase other bonds with over $2,000,000 delivered to Dean & Co. for that purpose, while falsely representing to contractors and municipalities that the bonds had in fact been purchased and were being held by the company for their respective accounts. (Exh. 2, 6, 7 and 13; Stipulations 6-13, 15-17; T.58, 88, 112, 356). In addition, over $400,000 were obtained from non-contractor customers of Dean & Co. upon Dean's misrepresentation that said funds would be used to purchase municipal bonds for

said customers or that municipal bonds deposited by those customers with Dean & Co. would be held by it. The deposited bonds were later sold at Dean's direction without authorization by the customers (Stipulation 14, Exh. 7 and 15; T.58, 155-157). Indeed, Dean even contrived interest schedules and paid fictitious "interest" out of Dean & Co.'s operating bank accounts on the non-existent bonds until the company's demise (Exh. 13, T.115-116).

By means of and as an element of these schemes, Dean applied at least $557,000 of Dean & Co. funds to his personal use including gambling, stock transactions and other personal investments (Exh. 8, 11, 12, T. 63-88). At least $250,000 of corporate funds were directly transferred from the corporate checking account to Paul Dean's personal checking account at Chemical Bank (Exh. 4,8, 12; T. 82). Those funds would have been unavailable to Dean in the absence of his dishonest acts since Dean & Co. was operating at a loss during the entire relevant period (T.87, 88).

On April 4, 1973, Dean & Co. assigned its assets to Justin L. Vigdor as Assignee for the Benefit of Creditors. As of that date, Dean & Co. had neither municipal bonds nor funds to reimburse those for whom it had supposedly purchased bonds. The shortage was substantially in excess of the $250,000 fidelity coverage (Exh. 15; T.62, 64, 65). On April 30, 1973, an involuntary petition in bankruptcy was filed against Dean & Co. and on May 30, 1973 Justin L. Vigdor was appointed Receiver in Bankruptcy (Stipulation 1).

Nichols did not learn of the failure to purchase bonds, the unauthorized sale of bonds, and the unauthorized appropriation of corporate funds by Dean for his personal use until March 30, 1973 (T. 150-152). On one occasion Nichols borrowed money from the Bankrupt for a personal investment; any other payments of corporate funds to Nichols, other than salary, were repayments to him of Dean & Co.'s indebtedness (T. 164). Nichols also approved corporate loans for the purposes of investing in Sande Broadcasting Co. in the belief that such corporate funds were derived from the operating profit of the company (T. 185). Indeed Nichols had believed that the company was profitable. (T 146, 110-119, 185, 219).

On or about October 15, 1966, the first of two Brokers Blanket Bonds was issued by Aetna to the Bankrupt, indemnifying the insured for losses caused by the fraudulent and dishonest conduct of employees of the corporation. On October 15, 1971, the original bond was renewed by the issuance of a new form by Aetna (Attachment B to Complaint) and continuous fidelity coverage existed during the entire period between October 15, 1966 and April 4, 1973. (T. 48, 49)

The Bonds were purchased by the Bankrupt through Peter Paris of the Paris, Budlong & Esse Insurance Agency, a duly authorized agent for Aetna during the period of October 15, 1966 through September 4, 1973 (T. 46, 47).

Upon becoming Assignee for the Benefit of Creditors, Justin L. Vigdor discovered that Dean & Co. had suffered losses as the result of

the fraudulent and dishonest acts of Dean (T.356). Immediately thereafter and during the period of April 4 through April 9, 1973 he gave written and oral notice to Aetna of a claim under the Bond. (Exh. 14, 25; T. 363). Prior to the expiration of the six month period from discovery of the loss as aforesaid, within which to file a proof of loss (Section 4 of the Bond, Attachment B to Complaint) Aetna denied coverage under the Bond on several grounds including failure to file a proof of loss (Exh. 25; T. 334, 335).

Mr. Vigdor testified that within the period of April 4, 1973 through April 9, 1973 Peter Paris represented to him that the coverage under the Bond had been increased from the original amount of $200,000 to $250,000, that Aetna had been properly notified, that the full amount of the Bond had been reserved, that payment was merely a matter of mechanics and that Paris would take all actions necessary to comply with the terms and conditions of the Bond (T. 364). Peter Paris was not called as a witness and Mr. Vigdor's testimony in this respect was uncontroverted.

In an attempt to satisfy Aetna's request for information and to prove the loss in question, Mr. Vigdor corresponded with Aetna, provided summaries and physically exhibited documents to Aetna. Furthermore, he requested specific information from Aetna as to what information, if any, was further required for the processing of the claim (Exh. 25, T. 291, 294, 296, 298, 304, 314, 321, 324, 325, 331). Instead of complying with all terms and conditions of the Bond as

promised, Peter Paris requested that Aetna name Mr. Vigdor as an additional insured under the Bond, and when Paris was informed that such action was not possible, he requested a return premium and failed to take further action (Exh. 25; T.270-272).

In violation of its own internal underwriting and claims regulations and procedures, Aetna failed to conduct any independent investigation whatsoever as to the claim made by the Appellant herein and sought to frustrate the Appellant and his predecessors in perfecting or attempting to perfect the claim. In fact, after deciding as early as May 14, 1973 to refuse payment under this claim, Aetna consciously attempted to delay Appellant's efforts to perfect said claim so as to allow time periods to lapse and to utilize said lapses as defenses to Appellant's claim. (Exh. 25, 26, 27, 29-31; T.230-257, 312, 313, 338).

## POINT I

AETNA MUST BE HELD TO HAVE ASSUMED ANY RISK WHICH WAS NOT CLEARLY AND EXPRESSLY EXCLUDED SINCE ANY AMBIGUITIES IN THE BOND MUST BE STRICTLY CONSTRUED AGAINST AETNA.

Fidelity bonds are subject to the rules of construction generally applicable to insurance policies (American Surety Co. vs Pauly, 170 U.S. 133, 42 L. Ed. 977, 18 S. Ct. 552, 1898; First National Bank vs. National Surety Co. 228 N.Y. 469, 1920). It is well settled that ambiguities in insurance contracts are strictly construed in favor of the insured. Accordingly where fidelity bonds are reasonably susceptible of two constructions, that construction will be adopted which favors the liability of the surety or insurer for the act or default in question. (Brogan vs. National Surety Co. 246 U.S. 257, 62 L. Ed. 703, 38 S. Ct. 250, 1917; Kean vs. Maryland Casualty, Co. 221 A.D. 184, aff'd. 248 N.Y. 534, 1928).

Where a bond does not specifically exclude coverage with regard to a particular matter, courts have tended to favor the insured and have considered the loss to be included within the policy coverage. Thus, in Cohon vs. U.S. Fidelity & Guaranty Co., 172 Misc. 51, (1939), aff'd 259 A.D. 707, where the fidelity bond excluded losses resulting from "trading, actual or fictitious," and there was conflicting expert testimony as to whether the term included retail over-the-counter sales for a net price, the Court resolved the ambiguity in favor of the insured.

In Fidelity & Deposit Co. of Maryland vs. Usaform Hail Pool, Inc., in construing a fidelity bond, the Court observed:

> "It has become obvious to the Court that F and D has not known from the start of this matter to this point, just what position it should take with respect to its coverage defenses. It is equally obvious that the printed form of the bond issued by F and D simply does not fit the unusual circumstances of this case. F and D knowing of these anomalies and knowing that issuance of such a bond in a situation such as this was most unusual walked into this loss with its eyes wide open." (318 F. Supp. 1301, M.D. Fla. 1970, rev'd on other grounds, 463 F. 2d 4, 5th Cir. 1972). (hereinafter cited as Usaform).

In this appeal, this Court must consider whether in light of the well settled rule of strict construction, Aetna should be determined likewise to have "walked into this loss with its eyes wide open."

That determination hinges on the disposition of the following questions:

A. Was Dean an "Employee" within the meaning of Section 1(a) of the Bond?

B. Was there a loss within the meaning of the fidelity coverage set forth in Insuring Agreement A?

C. If, as we believe, Appellant has answered both these questions in the affirmative, has Aetna established, by a preponderance of the evidence (in spite of the rule of strict construction) that this covered loss fell within some exclusion contained in the Bond?

We submit that the argument which follows will make it plain that Aetna has failed to carry this burden as a matter of law and the judgment should be reversed.

## POINT II

PAUL R. DEAN, THE COMPANY PRESIDENT, HAD BEEN EMPLOYED AS GENERAL MANAGER OF DEAN & CO. PURSUANT TO A WRITTEN EMPLOYMENT CONTRACT, RESPONSIBLE FOR DIRECTING DAY-TO-DAY OPERATIONS OF THE COMPANY AND WAS INDISPUTABLY AN "EMPLOYEE" WITHIN THE MEANING OF SECTION 1(a) OF THE BOND AS A MATTER OF LAW.

The Bond is Attachment B to the complaint. An "employee" is defined in Section 1(a) as "one or more of the Insured's officers, clerks and other employees while employed in, at or by any of the Insured's offices". Section 2(d) of the Bond excludes coverage for any "loss resulting from any act or acts of any person who is a member of the Board of Directors of the Insured or a member of any equivalent body by whatsoever name known unless such person is also an Employee or an elected official of the Insured in some other capacity, nor, in any event, loss resulting from the act or acts of any person while acting in the capacity of a member of such Board or equivalent body..."

Being President of Dean & Co., during the term of the Bond, Dean was plainly "one of the Insured's officers". While he may have been the owner of 50% of the stock of the Company, nothing in the Bond precludes a 50% shareholder or even a majority shareholder from being an employee. Moreover, he was actually employed pursuant to a written employment contract (Exh. 16) and was assured of such employment by a written Shareholder's Agreement (Exh. 17).

In Insurance Co. of North America vs. Greenberg, 405 F. 2d 330, 333 (10th Cir., 1969), the Court construed a similar definition of "employee" in a fidelity bond as intending "to exclude from the definition of 'employee' only those directors who functioned as outside directors and not those who functioned as director and officer and who received a salary for services rendered in such capacity". It should be noted that in the fidelity bond in the Greenberg case, the definition of employee was measurably more restrictive and favorable to the insurer's position than the definition contained in Aetna's Bond. In Greenberg, the definition required that an "employee" be one whom the insured "has the right to govern and direct in the performance or such service..." Nonetheless, the Court stated "Nor can it be said that Hoster and Arnold are excepted from said definition because they governed rather than were governed by the corporation for they were neither the sole directors nor the sole or majority shareholders of Oklahoma Steel..."

Dean clearly falls within the definition of "employee". The fact that he was a director does not operate to exclude him from that class since, in essence, "A director's duties ordinarily consist in attending meetings, exercising his judgment on proposed policies for the corporation and voting thereon." (Phoenix

Savings and Loan vs. Aetna Casualty and Surety Co., 427 F. 2d 862, 872, 1970). As a matter of law the dishonest acts performed by Dean in his capacity as General Manager and President, were not within Section 2(d) of the Bond, which excludes "loss resulting from the act or acts of any person while acting in the capacity of a member" of the Board of Directors. Conclusion of Law No. 1 to the contrary should be reversed.

POINT III

DEAN'S CRIMINAL SCHEME INVOLVED A DIVERSION OF CORPORATE FUNDS WELL IN EXCESS OF THE FACE AMOUNT OF THE BOND TO A VARIETY OF ILLICIT PERSONAL USES AND RESULTED IN RESIDUAL LIABILITIES, FOR WHICH THE CORPORATION AND ITS REMAINING SHAREHOLDER ARE RESPONSIBLE AND ARE WITHOUT FUNDS TO MEET, ALL OF WHICH CLEARLY CONSTITUTES A COVERED LOSS WITHIN THE MEANING OF THE BOND.

Admittedly, before an insured can establish liability against the insurer, the insured must demonstrate that it has suffered a loss. The Courts have held that such loss must be pecuniary in nature and that "neither 'wash' transactions nor frauds on creditors make out insured losses". (Usaform, 463 F. 2d at p. 6). In Usaform, the Circuit Court found that no loss was established where trust funds were used by the dishonest employee to pay legitimate corporate obligations since the corporation, as distinguished from the beneficiaries of the trust, had suffered no loss, but had merely substituted one creditor for another. The Court, however, went on to say that a loss would result where

there was a reduction of a corporation's assets available as against its liabilities to depositors, creditors, or stockholders. Here, the assets available to Dean & Co., were reduced by Dean's use of corporate funds for personal noncorporate purposes and hence were unavailable to apply against its ultimate liability to repay customers such as the City of Rochester and Penfield School District.

Similarly, in Banco de San German, Inc. vs. Maryland Casualty Co., 344 F. Supp. 496 (D.C. Puerto Rico, 1972), the Court held that, even where employee dishonesty results in loss to customers, the insured can recover under the fidelity bond as long as actual pecuniary loss occurs for which the insured is ultimately liable. The Court found that it was "not vital" that the loss directly impact the insured rather than initially its depositors or customers. (344 F. Supp. at 50).

The testimony adduced at trial revealed that, although the funds of customers were deposited directly into the corporate checking account of Dean & Co., Dean merely used this account as a conduit passing through these funds to himself. Indeed, the uncontroverted evidence demonstrated that funds substantially in excess of $250,000 were directly transferred from the Dean & Co.

bank account to Dean's personal account or made payable to "cash" and cashed by Dean. These funds were applied by him to a variety of non-corporate, personal purposes including at least $47,000 of established gambling losses. Under the reasoning in In re Schluter, Green & Co., 93 F. 2d 810 (4th Cir. 1938), a loss would be created by the depositing of dishonestly obtained funds in the insured's bank account where "the company thereafter lost the funds as a result of dishonesty or criminal conduct." Certainly, the application, by Dean, of hundreds of thousands of dollars of Dean & Co. funds to his personal use, must be considered dishonest.

The case of Bass vs. American Insurance Co., 493 F. 2d 590 (9th Cir., 1974) is remarkably parallel in this regard. That suit was brought by the trustee in bankruptcy of a bankrupt municipal bond dealer. Among the dishonest acts claimed by the trustee to have been committed by the employees was the failure to purchase bonds for delivery to customers. The funds were, instead, deposited into the company's general operating account. These sums were then used to pay the regular and normal operating expenses of the company. The lower court had held that the use of the funds for such purposes was not covered by the bond, citing Usaform, supra and Levey vs. Jamison, 82 F. 2d 958 (4th Cir., 1936). The Court of Appeals affirmed this holding, but pointed out that the trustee did not contend that the officers of the

company had diverted funds for their own use. The inference is clear, that if such diversion had taken place, a covered loss would have been demonstrated. Thus, Dean's diversions of sums dishonestly obtained from customers, constitutes a covered loss under Aetna's Bond.

In General Finance Corp. vs. Fidelity & Casualty Co. of N.Y., 439 F. 2d 981 (8th Circuit, 1971) the Court stated:

> "The records of GFC failed to show any legitimate grounds upon which such diversion of funds were made. Mr. Leach was present during the entire trial, heard the testimony and offered no explanation or refutation. We hold the appellant made out a prima facie case under these circumstances and the burden shifted to the appellee to offer its proof in explanation or contradiction." (439 F. 2d at 986)

Here Appellant brought Dean into Court by a Writ of Habeas Corpus Ad Testificandum and yet he refused to testify, relying upon his constitutional right against self incrimination. He offered no explanation or refutation of plaintiff's evidence, nor did Aetna bear its burden to offer any proof in explanation or contradiction.

## POINT IV

AS A MATTER OF LAW THE ACTS OF PAUL R. DEAN WERE "DISHONEST" WITHIN THE MEANING OF THE BOND.

Despite uncontroverted evidence and Appellant's Proposed Findings of Fact and Conclusions of Law (Docket item No. 21), the Court below made no finding whatsoever regarding dishonesty

on the part of Dean. Unquestionably, all Courts dealing with the subject have held that the terms "dishonesty" and "fraudulent conduct" when used in a fidelity bond, are to be given broad meaning. (See Citizens State Bank vs. Transamerican Insurance Company, 452 F. 2d 199, 7th Cir., 1971).

The leading New York case on the question of what constitutes dishonesty within the meaning of a fidelity bond is World Exchange Bank vs. Commercial Casualty Insurance Company, 255 N.Y. 1 (1930). Chief Judge Cardozo stated, in the widely-cited opinion at page 5:

> "...dishonesty within such contract may be something short of criminality. The appeal is to the mores than to the statutes. Dishonesty, unlike embezzlement or larceny, is not a term of art. Even so, the measure of its meaning is not a standard of perfection, but an infirmity of purpose so opprobrious or furtive as to be fairly characterized as dishonest in the common speech of man. 'Our guide is to the reasonable expectation and purpose of the ordinary businessman when making an ordinary business contract.'"

This definition was cited with approval by the Eighth Circuit in Fidelity & Deposit Co. of Maryland vs. Bates, 76 F. 2d, 160, 167 (1935) and by the Seventh Circuit in London and Lancaster Indemnity Co. vs. People's National Bank and Trust Co., 59 F. 2d 149 (1932), where the Court at page 152 stated that if the act in question indicated "...a reckless, willful and wanton disregard for the interest of the employer--if it be an act manifestly unfair to the employer and palpably subjects him to likelihood of loss--a fact question of liability for loss thereby ensuing, as from a dishonest act, is fairly raised."

Under the holdings in Bass and In Re Schluter, Green, (cited under Point III, supra), which dealt with similar or identical conduct, it is apparent that Paul Dean's failure to purchase bonds when he indicated that the bonds had already been purchased, his sale of bonds deposited with the insured in safekeeping and his personal use of funds thus obtained were all "dishonest" acts under the terms of Insuring Agreement A of the Bond.

## POINT V

AS A MATTER OF LAW, AETNA HAS FAILED TO ESTABLISH ITS AFFIRMATIVE DEFENSES BASED UPON THE EXCLUSIONARY THEORIES OF "ALTER EGO" OR "SOLE CONTROL" OR TO PLEAD AND PROVE THAT THE LOSSES IN QUESTION WERE MERELY CORPORATE LOANS TO DEAN.

A. No defense exists to Appellant's claim by virtue of Dean's day-to-day management of the operations of Dean & Co.

In paragraphs 18-22 of its Answer, Aetna has set forth an affirmative defense that, inter alia, "any acts of Paul R. Dean complained of were the acts of Paul R. Dean & Co., Inc.". This defense is predicated upon the "alter ego" or "sole control" theories previously advanced by Aetna and other fidelity insurers in a number of reported cases.

The rationale behind this defense is basically that one in sole control of an insured should not be allowed to insure himself and profit from his own fraud. To prevent such an undesirable

result, several courts have denied coverage by imputing to the insured the knowledge of one in sole control. In accomplishing this result, these courts have utilized the imputed knowledge so as to find that, under the particular bond in question, (a) there was a failure of the "insured" to promptly notify the insurer after "discovery of the loss", (b) the bond was invalid because the fraud was "concealed" by the "insured" at the bond's inception, (c) the "insured" ratified the dishonest acts or (d) the bond terminated immediately upon the first "discovery" by the "insured" of dishonest acts on the part of the "controlling employee". Clearly, each such rationale is predicated upon the belief that one who is in sole control should not be allowed to benefit from his own wrongdoing.

Thus, in Kerr vs. Aetna, 350 F. 2d 146 (4th Cir. 1965), losses created by the owners of 75 percent of the insured's stock were held to be nonrecoverable under the terms of Aetna's fidelity bond. However, in Phoenix Savings and Loan, Inc., cited under Point II, supra, Usaform, cited under Point I, supra, F.D.I.C. vs. Lott, 460 F. 2d 82 (5th Cir., 1972), and General Finance Corp., cited under Point III, supra, the Courts declined to exclude coverage based upon the exclusionary theories of "sole control" or "alter ego".

In F.D.I.C. vs. Lott, the Court stated:

> "Innocent shareholders and creditors should not have to bear a loss when the fraudulent majority shareholder will not benefit from his fraud." (460 F. 2d at 87)

In that case, the defalcating party was a 52 percent shareholder of the insured, and the Court declined to impute the knowledge of fraudulent activity by this majority shareholder to the insured corporation.

In General Finance Corp., supra, the Court addressed the issue as one of policy construction and observed:

> "If majority stock ownership was thought to pose an unacceptable hazard, the insurer could have inserted a provision in the policy concerning stock ownership.
>
> * * *
>
> "The fact, if true, that the directors were generally but a 'rubber stamp' is not controlling here. The policy did not require that the Board of the assured generally make independent decisions. The issue under the terms of the policy is did they have 'the right to govern and direct'..." (439 F. 2d at 984).

Judge Burke below did not conclude that Dean was the "alter ego" of Dean & Co., or that he was in "sole control" but rather that he was the "sole operating entity" (Conclusion No. 1). This distinction is critical and very probably was based on the legal effect of the uncontroverted evidence that, as a 50 percent shareholder and director, Nichols had the right to participate in

major decisions. Indeed, on occasion, he did so. ((e.g. T. 147 (raising capital); T. 153-155 (purchase of Sande Broadcasting Company); T. 170 (the closing of the Atlanta office)).

The risk of dealing with a "sole operating entity", whatever that may mean, was clearly not excluded by the language used by Aetna in the Bond--particularly in the context of the present state of facts. Nor does the Bond, strictly construed, make "abdication of responsibility" by Nichols a defense.

Since the Court below was so concerned with "abdication of responsibility", one wonders why Aetna's own fundamental abdication of responsibility was overlooked. Ignoring its own underwriting manual (Exhibit 20), Aetna failed to obtain "the most detailed description of the business operations of the insured" (T 230-231); failed to obtain Aetna's own Form F1146 (Stockbroker's Loss Control Questionnaire) two months before renewal of the Bond (T. 232-233); failed to verify the insured's procedures for the control and custody of securities; failed to make inquiries despite ambiguous, incomplete and contradictory information on three questionnaires (Exhibits 21, 22, 23; T. 241-255); failed to question delays in receiving such questionnaires and Dean & Co.'s lack of current financial reports (T. 242-243). Actually, Aetna affirmatively sought this underwriting despite all the foregoing (T. 257).

Plainly, Dean's day-to-day management of the insured's affairs were either known to Aetna or irrelevant to it by reason of the language of the Bond. To borrow a phrase from the District Court in Usaform (318 F. Supp. at 1312), Aetna "...walked into this loss with its eyes wide open." Since there is no way in which Paul Dean can personally benefit from a legal conclusion that coverage exists, no public policy consideration should deter this Court from reversing the judgment of the Court below.

B. The Findings of Fact and Conclusion of Law upholding Aetna's defenses are themselves logically and legally deficient.

In Judge Burke's Conclusions of Law he stated:

> "(3) Nichols was either aware of the financial condition of the company, or by his failure, as claimed by him, to make any effort to familiarize himself with the operation of the company, had entrusted the entire operation of the company to Dean. If Nichols was aware of the financial condition of the company, Nichols' knowledge of fraud is imputable to the company. If Nichols abdicated his responsibility as director and entrusted the operation of the company entirely to Dean, knowledge of the fraud by Dean was imputable to the company. Dean and Nichols were the alter ego of the Dean Company. Knowledge of fraud on the part of Dean or Nichols or both, is imputable to the company."

Appellant respectfully urges that this Conclusion is plainly erroneous. Awareness of the financial condition of the Company is not equivalent to knowledge of fraud committed by Dean as an employee. Nor is entrusting the operation of the

the operation of the Company to the Company's President and General Manager--himself a director and 50 percent shareholder--equivalent to knowledge of fraud.

Significantly, the quoted Conclusion refrains from making the single finding on which the Conclusion may legally rest--that Nichols had actual knowledge of Dean's fraud. Instead, the Court has constructed a series of premises which are hypothetical and immaterial in view of the language of the Bond and the rules of strict construction.

In view of the Court below, the Company had knowledge of fraud and cannot recover:

(a) If Nichols was aware of its financial condition, or

(b) if Nichols entrusted the operation of the Company to Dean

Either of the foregoing is then equated to knowledge of fraud on the part of Nichols and "knowledge of fraud on the part of Dean or Nichols or both is imputable to the company" [emphasis supplied].

We agree only with so much of Conclusion No. 3 as holds that together "Dean and Nichols were the alter ego of the Dean Company" and that "knowledge of fraud on the part of...both is imputable to the company." The doctrine of strict construction insists that knowledge on the part of Dean alone is insufficient and can

not be bootstrapped by theories of abdication, negligent failure to inquire, or other varieties of constructive notice which might suffice when interpreting other writings but not a fidelity bond in which Aetna itself expressly defined the risks which it declined to accept and for which it accepted premiums for six and one half years. The very purpose of the Bond was to furnish the Company (and the Appellant who stands in the shoes of the Company) a measure of indemnity which had been bought and paid for.

C. Aetna failed to plead or prove as an affirmative defense the exclusionary terms of the Bond relating to loans to officers or directors.

Inferentially, the Court characterized the expenditures of corporate funds by Dean for his own personal use as merely creating loans from the corporation to Dean, and thus, not covered losses within the meaning of the Bond. This characterization of the defalcation as loans may have resulted from the accountant's method of analyzing Dean's personal transactions after the Company's failure (T. 62-65; Exh. 8). In any event, in Finding 11, Judge Burke stated:

> "The bond did not cover losses resulting from loans obtained from the insured or any of its partners, directors or employees, whether authorized or unauthorized."

Admittedly, Section 2(e) of the Bond excludes:

> "loss resulting from the complete or partial non-payment of, or default upon, any loan or transaction in the nature of, or amounting to, a loan made by, or obtained from the Insured to any of its partners, directors, or Employees, whether authorized or unauthorized and whether procured in good faith or through trick, artifice, fraud or false pretenses..."

However, since Aetna did not disclaim liability under the Bond based upon the terms of this exclusion (Exhibit 25) and did not include this exclusion among its seven other affirmative defenses herein, Aetna must be deemed to have waived that exclusion as a defense to Appellant's recovery.

## POINT VI

THE LOSSES WERE DISCOVERED ON MARCH 30, 1973, WITHIN THE TERM OF THE BOND, AND NOTICE WAS GIVEN TO AETNA IN A TIMELY MANNER THEREAFTER.

The Bond requires that a covered loss must be discovered during its term and that notice thereof must be given "at the earliest practicable moment" thereafter, and that proof of loss be filed within six months thereafter (Section 4).

Aetna has claimed that Appellant failed to give notice of loss at the "earliest practicable moment" after discovery of the loss. additional justification for its denial of Appellant's claim, Aetna refers to the termination language in Section 11(c) of the Bond, to the effect that termination takes

place "immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials".

Since the Assignee for the Benefit of Creditors, Justin L. Vigdor, was appointed on April 4, 1973, Aetna claims that the Bond terminated on that date and that losses discovered thereafter by the Assignee would not be covered under the renewal bond. The argument must fail because the losses in question were discovered by the insured on March 30, 1973, prior to the termination of the Bond. "Discovery" is defined by the Courts as that time when the insured gains sufficient factual knowledge, not mere suspicion, which would justify a careful and prudent man in charging another with dishonesty. (American Surety Co. vs. Pauly, supra p. 8.) "There must be acts coming to the knowledge of the employer that involve bad faith, willfulness, a breach of honesty, a want of integrity, or moral turpitude affecting the official fidelity or moral character of the employee..." (Schrieber Travel Bureau v. Standard S. & C. Co., 240 A.D. 279, 282 (2d Dept. 1934).

Because, as has been argued earlier, it is manifestly unreasonable to suppose that Paul Dean would do otherwise than keep his own dishonesty a secret, his knowledge alone prior to March 30, 1973, was not imputable to Dean & Co. (See Point V supra; also see Hall v. Aetna Casualty & Surety Co., 89 F. 2d 885, 2nd Cir., 1937, cert. den. 302 U.S. 725; Maryland Casualty Co. v. Tulsa

Industrial L. & Inv. Co., 83 F. 2d 14, 10th Cir., 1936, 105 ALR 529).

On March 30, 1973, Nichols, himself a personal guarantor of certain of the Company's obligations (T. 155-156, 202), first learned that Dean & Co., was not in possession of the municipal bonds purportedly purchased to be held in lieu of retained percentages for certain contractors (T. 148-149, 159-160). This was corroborated by the Company's secretary. (T. 127-129). He was unaware prior to that time that Paul Dean had expended large sums of corporate funds for personal purposes, that the Company had a substantial retained earnings deficit and that the funds, utilized by Nichols and Dean for the investment in Sande Broadcasting Co., had not been derived from the operating profit of Dean & Co. (T. 151-155; 164-165; 185, 219).

This knowledge obtained by Nichols and later confirmed by the Assignee constituted the first knowledge of facts obtained by Dean & Co., sufficient to justify the conclusion that Paul Dean was guilty of dishonesty or fraud.

The first notice of loss given to Aetna by Appellant or his predecessors on behalf of the insured, took place on April 4, 1973, barely five days after the first discovery of the loss by Nichols. In Fidelity & Deposit Co. v. Courtney (186 U.S. 342, 46 L. Ed. 1193, 22 Sup. Ct. 833, 1902) the Supreme Court

stated that the requirement, in such fidelity bonds, that notice of loss be given immediately after discovery of the loss, means that notice should be given within a reasonable time. In that case, notice given from ten to seventeen days after discovery was held to be reasonable. Likewise, in National Surety Corp. v. Hall, 107 Colo. 150, 109 P. 2d 905 (1940) notice given about five days after discovery of loss was held to satisfy the requirement that notice of loss be given "immediately after discovery". A fortiori, the same five day period, in the instant case, satisfies the Bond's requirement that notice be given "as soon as practicable" after discovery.

## POINT VII

IN VIEW OF THE SERIES OF COMMUNICATIONS WITH AETNA AND ITS AGENTS AND IN VIEW OF AETNA'S REJECTION OF THE CLAIM WITHIN SIX MONTHS, THE PROOF OF LOSS REQUIREMENT WAS, AS A MATTER OF LAW, EITHER COMPLIED WITH BY APPELLANT OR WAIVED BY AETNA.

All the meetings and correspondence between Justin Vigdor, Assignee for the Benefit of Creditors, and his representatives, and Aetna's agents and employees, together with telephone communications and demonstration of documents to Aetna's claims manager (T. 259-335; Exhibits 14, 25-32), constituted a sufficient, perhaps overwhelming, proof of loss to Aetna. There are "None so blind as those that will not see." In any event, by its September 4, 1973 letter (part of Exh. 25), Aetna waived

the requirement that proof of loss be submitted within six months of discovery of the loss. This letter was dated prior to the expiration of the stipulated period for submitting proof of loss. Since the date of discovery was March 30, 1973, the six-month period ended September 30, 1973. Although several grounds were enumerated, Aetna denied coverage "on the merits"--on grounds other than mere failure to submit timely proof of loss.

There can be no doubt that repudiation of liability by an insurance company before the expiration of the period prescribed for filing proof of loss excuses the insured from further performance of the conditions of the policy. (Sherri vs. National Surety Co., 243 N.Y. 266, 273, 1926; Beckley v. Otsego County Fire Ins. Co., 3 A.D. 2d 190, 3d Dept., 1957; Bornas v. Standard Accident Insurance Co., 5 A.D. 2d 96, 4th Dept., 1958; Foreign Credit Corp. v. Aetna Casualty and Surety Co., 276 F. Supp. 791, S.D. N.Y., 1967; Canales v. Stuyvesant Insurance Co., 172 N.Y.S. 2d 729, N.Y. City Court, 1958).

## POINT VIII

PUBLIC POLICY CONSIDERATIONS ENTITLE APPELLANT TO PUNITIVE DAMAGES AS A RESULT OF AETNAS UNJUSTIFIED REFUSAL TO PAY, ITS MISREPRESENTATIONS AS TO ITS INTENTION TO PAY AND ITS UNCONSCIONABLE ATTEMPTS TO FRUSTRATE AN OFFICER OF THE COURT IN PRESENTING A CLAIM UNDER THE BOND.

In <u>Wetherbee v. United Insurance Company</u>, (265 Cal. App. 2d 921, 71 Cal. Rptr. 764, sub. app. 18 Cal. App. 3d 266, 95 Cal. Rptr. 678), the Court established the principle that an insurer who makes fraudulent representations to the insured of coverage which it does not intend to provide becomes liable to the insured in punitive damages.

In <u>Fletcher v. Western National Life Insurance Company</u>, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78, 47 ALR 3d 286 (1970), the Court upheld the principle of awarding punitive damages for the conduct of an insurance company which is of such a nature so as to prevent the insured from obtaining proceeds of the policy to which the insured was entitled.

In <u>Walker v. Sheldon</u> (10 N.Y. 2d 401, 1961), the applicability of punitive damages was extended to actions in fraud and deceit, where the defendant's conduct evinces high moral culpability.

Even in these cynical days, it is difficult to imagine shabbier, more commercially reprehensible tactics than Aetna's handling of the claim in this case. Dean & Co., had collapsed and was in a shambles. Well over $2 million in municipal bonds were missing. The original Bond was uncovered in the Company's files by an Assignee for the Benefit of Creditors within days after March 30, 1973, the date of discovery. Stanley Dye of

Coopers & Lybrand, the auditors engaged by the Assignee, personally gave notice to Peter Paris, Aetna's undisputed agent (T. 46, 47) who in turn gave notice to William Michener, Manager of Aetna's Bonding Department. Michener had also received notice from an attorney for the Corporation and from Dye (T. 259). Dye was told by Paris that Paris was writing Aetna a letter and that "Bill Michener says that Aetna has been properly notified". (Ex. 14).

Telephone calls and letters from Paris were received by Aetna (T. 260-261, 284; letter Paris to Aetna 4/9/73, part of Exh. 25). Indeed, Michener met with the Assignee and, discounting any conflict of interest, bonded the Assignee (T. 262-263). Paris assured the Assignee that Aetna had been properly notified and the face amount reserved. (T. 368-370).

Everyone, including Michener (T. 263-265), Putnam (Aetna's claims manager), Paris, and the Assignee (T. 268-269), was confused about the existence of a different form renewal bond and the import of certain of its terms.

Instead of engaging in constructive dialogue or meeting in good faith in an effort to dispel the confusion, Aetna then commenced an unconscionable "cat and mouse game" which violated the fairness procedures mandated by its own Claims Manual (Exhibit 26; T. 289-290).

Concerned with the possibility that the Assignee might request an extension of time for additional discovery, Aetna deliberately refrained from dispelling the confusion so as to permit one 30-day period to elapse. (T. 300-301).

For transparent commercial amorality, it is hard to equal the memo of May 14, 1973 (part of Exhibit 25), where Aetna's home office, after summarizing the Assignee's efforts to give notice and gain clarification, told Putnam:

> "It seems to me that Vigdor came pretty close to requesting the required extension.
>
> * * *
>
> Hopefully, this is a one man corporation and the acts of Dean would be the acts of the insured."

And the memo from the Home Office of May 15, 1975 (Exhibit 25):

> "Suggest you do nothing but sit tight and await developments."

And the subsequent course of obscure behavior and deliberate inaction on the part of Aetna between that date and the denial of coverage on September 4, 1973 (see letters from Vigdor to Aetna dated June 14, 1973, July 19, 1973, Aetna letter to Vigdor dated July 20, 1973, Vigdor's letter to Paris dated July 23, 1973, Vigdor's letters to Putnam dated July 27, 1973, August 14, 1973, and August 29, 1973--all part of Exhibit 25).

Appellant respectfully submits that even were this Court to reverse the judgment below, as Appellant of course believes it should, this would have little deterrent effect on Aetna and other insurers in the future, as the wrongdoer would simply be obliged to pay what was legally due from the outset. We urge this Court to hold that public policy sanctions, indeed, demands, that exemplary damages be imposed when hindrance and delay on the part of an insurer are as morally culpable as they were in Aetna's dealing with the court-appointed Receiver and Trustee in this case.

## CONCLUSION

FOR THE REASONS SET FORTH ABOVE THE JUDGMENT APPEALED FROM SHOULD BE REVERSED AND APPELLANT AWARDED JUDGMENT AGAINST AETNA AS TO EACH AND EVERY CAUSE OF ACTION CONTAINED IN THE COMPLAINT.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

| | |
|---|---|
| Joseph S. Carges as Trustee in Bankruptcy of PAUL R. DEAN & CO., INC., | : |
| Plaintiff-Appellant, | : |
| -vs- | : |
| AETNA CASUALTY AND SURETY CO., | : |
| Defendant-Appellee. | : |

TABLE OF CASES